McDonald's

Economics of Organizations
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Abstract
This case study aims at analyzing the economics and structure of the incentive systems of McDonald's. McDonald's has a tradition of incentive payment system, in this study four earlier plans for compensating and motivating unit managers are evaluated on base on the chief determinants on this level.

Plan A consists of a base salary determined by a range system and an additional monthly bonus. This is the best proposal since it gives an adequate distribution of measurement to all the areas important to the unit manager, and since it corresponds both to short-term individual utility maximizing and to long-term corporate growth.

Besides using distributing property rights by use of franchising, McDonald's have today also started using property rights in-house since their current incentive system consists of a combination of short term goals and rewards (annual salary and a bonus program called "Target Incentive Plan") and long term goal and rewards (stock options).

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2. INTRODUCTION

This case study aims at analyzing the economics and structure of the incentive systems of McDonald's.[1] To observe the performance of other agents is a difficult task. Hence, firms will create some kind of incentive system to promote and encourage performance. McDonald's has a tradition of incentive payment system, is this study four earlier plans for compensating and motivating unit managers are evaluated on base on the chief determinants on this level. Alternatives based on the distribution of property rights are then discussed. These are then compared to the system of McDonald's today.

3 COMPENSATION SITUATION

Chief determinants at unit level

McDonald's can measure its success at unit level by its:

1) Firm specific contribution, i.e. the capability of the restaurant to increase the profit of the company by increasing volume and market share.
2) General contribution, i.e. the capability of the restaurant to satisfy its customers and

[1] Where there is no other sources stated, the analysis is based on information from "Sasser – Pettway (1974), *Case of Big Mac's Pay Plan,* Harvard Business Review" and "Citanna, A. (2001), "*Economics of Organizations – lecture notes*", Groupe HEC".

thereby make them brand-loyal.

There is a temporal difference between the two forms of contribution. Since the first form of contribution is numerical and therefore easier to measure, it is also relatively easy to directly affect in the short-run. The second contribution is more abstract and gives the restaurant benefits in the long run by making the customers brand-loyal, which will increase profit. However, for the fast food industry this is a very important part since the commodities in question are very close substitutes and much of the attractiveness in the product is the consumers brand identification. Therefore there is a shared concern for a the brand-name reputation on all levels of the company.

The determinants of how success is achieved are depending on the unit's capability of sales, cost reduction and margins for the firm specific contribution. For the general contribution, what is most important for the unit is fulfilling the QSCV (Quality, Service, Cleanliness & Value), developing unit-specific inventiveness, and having managers with high motivating abilities.

Increased volume vs. reduced costs

In the early years the fast food wars were fought with heavy discounting arms where high volume compensated low margins. However, later on, when the commodity costs got higher and the minimum wage increased in the slow-growth environment, there was a demand for higher profits. McDonald's surrendered the strategy of sacrificing profits for market share by cutting prices to drive sales and volume. The company started raising menu prices across half its system.[2] Later on, in this highly competitive market, McDonald's changed strategy, aiming at binding customers to apply more monopolistic price policies. The very low prices was replaced by product initiatives and promotion to attract customers and increase margins, and now, the margin of McDonald's belongs to the highest of the industry.[3] Also, the competition is said to have changed the structure of profitability by eroding unit-level margins. Thereby it has become more difficult for restaurant managers to show growth in earnings and the impact of earnings growth from newly opened stores has decreased.

For the organization and distribution of tasks within the company, the high margin means that pushing volume is relatively more profitable for McDonald's than cutting costs. Volumes are best affected by decisions taken high up in McDonald's organizational structure, for example by division teams launching marketing campaigns or setting up new stores. However, even if cutting costs has not such a great relative significance to the overall profit, the impact of cutting costs is far from negliable. This task is performed by unit manager as well as the maintenance of long-term relationships and image - areas which should be concentrated on by incentive policies.

Designing the incentive systems

To observe the performance of other agents is a difficult task. Hence, firms will create some kind of incentive system to promote and encourage performance. In addition to the constant motivation, incentive systems also serve to progression paths and compensation systems that retain and reward individuals who have developed managerial skills and knowledge critical to the company's business needs. However, the incentives on managerial level is often given through compensating the officers' performance by payment.

[2] Papiernik, R., (1995).
[3] See Appendix 1.

Not only are incentives a way of motivation, it is also a way of directing work. There are many different tasks for each employment, and many tasks have several dimensions. The different tasks are discrete and mutually exclusive, that is if the officer performs one task this immediately implies that he cannot perform another. For example, if the officer chooses to make hamburgers he cannot also make french fries at the exact same period in time. The dimensions of the tasks are continous, they say by which preferences the officer has choosen to perform the task. Considering planning, for exemple, will the officer devote his time to stretgic planning or to plan day-to-day routines? Will the officer making hamburger try to make them as quickly or as good as possible? All tasks and dimensions are competing under the officer's effort and time budget restriction, that is, with a limited budget, the officer will give some activities preference to others.

For the firm a differentiated pay system entails costs. These are other important factors for the decision of which comensation plan to implement. The company costs are of different types, ranging from the individual to the external context.

1. *Risk Averse Officer*
   From a risk averse agents point of view, a variable pay induces a certain risk if measurement is imperfect. Therefore, a higher expected level of pay will be needed to compensate the officers.

2. *Moral Hazard*
   From the firm's point of view, an opportunistic, utility maximizing officer can take advantage of the possibility to trade between incentive provision and risk sharing, and the firm will face so called moral hazard problems.

3. *Directing Function*
   Some activities are more difficult than others to measure. Since intuitively all activities are competing substitutes under the budget restraint, an utility maximizing officer might therefore neglect activities that are desirable for the firm but which do not give as high pay-off to the officer through the compensation system. This implies that the more of the agent's various activities to be rewarded, the lesser is the risk that the officer will neglect parts of his or her tasks. The equilibrium might here be found within the firm since since an external market relationship could be too strong.[4] Thus, the use of low-powered incentives within the firm. So when "non-selling" activities become more important, the optimal adjustment is to reduce commission rates, i.e. sales incentives, combined with a decrease in the worker's freedom. A fraction of compensation paid in the form of commissions rather than salary is higher for independent agents.[5] In this case, low-powered incentives for easily measurable factors can be optimal to find an equilibria. If it is difficult to infer how much effort the agent spends on an important task, all tasks should have low-powered incentives.[6]

4. *Sabotage*
   If the incentives are too strong, wage compensation might give incentive for sabotage against other officers competing for the same compensation.

[4] Another way to come around this problem is to introduce property rights, se chapter 4.
[5] Rajiv, L. – Srinivasan, V. (1993).
[6] Holmstrom, B. - Milgrom, P. (1994).

5. *Filter*
   According to theory, pay should be contingent on all measures that are informative of the agent's action. In particular, pay should be contingent not only on firm performance, but should also be discounted for negatively dependence on industry performance, this a form of indexing to create a filter for common shocks.

4. PROPERTY RIGHTS AND INCENTIVES

Firms can use a variety of instruments to motivate workers for his or her array of tasks. Milgrom and Holmström launch the hypotheses that paying the agent based on measured performance, giving the workers ownership of assets and freedom from direct controls of for exemple working hours, are complementary[7] instruments which answers the eternal corporate question of whether to make-or-buy.

Traditionally, in an optimum, the importance of the three incentive schemes would be balanced, as weak incentives for maintaining asset values would mean weak incentives for measured performance and significant restrictions on worker freedom. However, all these are endogenous variables while variations in the cost of measuring performance, in asset specificity, and in future uncertainty are exogenous parameters. An increase in the cost of measuring sales performance acts like an increased input price, leading to the substitution of salary for commissions and to a complementary increase in worker rules.[8]

Also, when monitoring is imperfect and costly will only a narrow set of activities to be rewarded effectively by the firm. In this case, asset ownership gives a more profond and powerful incentive instrument. When an agent owns a set of productive assets, she maintains those assets more effectively and the risk of moral hazard is less. By contracting and work design, tasks and work rules can be specified on forehand to restrict the freedom of the worker. More tasks can also be allowed if the agent owns the assets and when pay incentives are strong. Then responsibility and authority go hand in hand.

5. PLANS FOR CHANGE – STRENGTHS AND WEAKNESSES

The original plan
In the original plan of 1972 the manager's compensation package consisted of a fixed salary and a quarterly bonus. While the fixed part was determined by a range system which took labor rates and other economic factors into account the quarterly bonus depended on the manager's ability to meet predetermined objectives of labor costs, food and paper costs, QSC and volume projections. Therefore, the manager could receive a maximum bonus of 20% of his base salary.
On the one hand this plan eliminated a lot of shortcomings and complaints of previous plans and reached to combine managerial incentives with corporate goals. But on the other hand unit managers complaint about complicated evaluation schemes, subjectivity and emphasis of volume patterns. For this reason the following four new plans were created.

[7] Complementary, i.e. using one of the tools more intensively increases the marginal benefit of using the others more intensively.
[8] Holmstrom, B. - Milgrom, P. (1994).

Plan A (Six factors)
Like the original plan also Plan A consisted of a base salary determined by the range system and a monthly bonus. This bonus depended on how the unit manager was rated by a regional operations staff according to QSC, training ability, volume and profit. Although this plan is a bit complicated, it seems to be the best proposal because it considers all things the unit manager himself can affect. Thus its strengths are not only the consideration of important corporate goals, a long term focus and the incentive rewards for profit and volume but also the acknowledgement of the importance of QSC to McDonald's success and the consideration of the manager's training ability. Weaknesses can be seen in its subjectivity and in a lack of balance. This means that four of the six factors require evaluation by a supervisor and that all factors are weighted equally. But certain modifications and good communications will make it understandable to participants.

Plan B (draw against commission)
Plan B places the manager on a draw against commission in the second year after receiving a base salary suggested by the range system in the first year. In this case the draw is the salary of the first year and the commission is a bonus depending on profit and volume.
This plan pleases a high growth environment and is excellent for managers who are risk-lovers because it offers unlimited payout potential. On the one hand its excessive dependence on the factors of profit and output gives little room for subjective intervention but on the other hand it excludes totally the impact of QSC. We have to ask ourselves if this can be in the interest of McDonald's corporation and if this package can adequately judge the manager's performance.

Plan C (supermanager)
This plan bases manager's total compensation solely on sales volume. Therefore it is called the "supermanager" program.
The only strength OF this plan is its objectivity because it is based only on sales volume. Implicitly the plan ignores all the other important elements of McDonald's success. The fact that it does not mention cost control can even lead to decreasing profits to the company.

Plan D (lump sum)
In this case a predetermined lump sum, which is based on the size of the management team and the volume of the store, is distributed among the management team. The percentage to be received by each team member depends on how the supervisors evaluate the manager's individual performance.
This plan contains so many weaknesses that you can only wonder about how McDonald's management can come up with such a proposal. First of all this plan rewards volume at the expense of other managerial virtues. Second it is based on a totally subjective evaluation. Third it is internally absolutely not consistent because the total available compensation increases faster through the addition of another person to the management team than it does through an increase in sales.

	Strengths	Weaknesses
Original Plan	▪ managerial incentive ▪ corporate goals	▪ complicated evaluation schemes ▪ subjectivity ▪ emphasis of volume patterns
Plan A (Six factors)	▪ corporate goals ▪ long term focus ▪ incentive rewards for profit and volume ▪ acknowledgement of the importance of QSC ▪ consideration of the unit manager's training ability	▪ subjectivity ▪ lack of balance ▪ complicated
Plan B (draw against commission)	▪ profit ▪ volume ▪ objectivity ▪ unlimited profits for risk lovers ▪ pleases high growth environment	▪ elimination of QSC ▪ excessive dependence on profit and output
Plan C (supermanager)	▪ objectivity	▪ ignores all the other important elements of McDonald's success ▪ no cost control ▪ threat of less profits
Plan D (lump sum)		▪ emphasizes volume ▪ totally subjective evaluation ▪ internally absolutely not consistent

Franchising – an alternative plan

Trying to find an optimum for the firm means trying to maximize the profits and lower the costs. In general it can be assumed that managers of corporate outlets are less risk loving than for exemple franchisees. If these managers are risk-averse, incentives to take risks would cost more. The only plan that has faced the problem of multiple tasks is plan A which has spread its measures to six additional areas. In this aspect there should be considered from managing direction the possibilty to use low-powered incentive to prevent misdirection. Considering the possible threath of sabotage, it is only plan D that is likely to have a problem in this field. To filter for common shocks is also done in the basic criterias when different restaurants are ranged relatively.

To out source the restaurants management through franchising is a way of motivating unit managers, here property rights are used as a mean to create incentive. Franchisees typically receive very strong ownership incentives, since they keep the added value of the unit. Unit managers, however, typically receive a smaller explicit incentive pay and no portion of the increase of their unit's value (they only benefit from national or corporate value growth). Thus, there is a strong correlation between incentives for enhancing the market value of the unit and incentives for immediate sales.

However, franchisees cannot sell the products of other firms, and their freedom is restricted by the many operating rules which are determined by the franchiser. Here can be seen an conflict with the supposed complemetary of high reward and asset right with high freedom – the franchisees are backbound by the many rules that will ensure the general capability of the restaurant.[9] However, there might be a difference between the franchising and industrial selling, the concern for a shared brand-name reputation in franchising, especially in fast food business. This explains the tight constraints and significant monitoring, as the control for food and service quality. Since the other activities that increase current sales and future value are practically the same as for an inhouse unit restaurant, ownership and commissions can become substitutes instead of complementary incentive instruments. The complementary of the three instruments mentioned earlier is essential for str[10]engthening the agent's portfolio of activities, so when just one of the incentives is increased, this might creating an undesirable substitution effect which has the opposite effect. So, however even though showing substitonary effects, this might not be unwanted since there are special characteristics of the fast food industry which calls for such a relation.

6. AN UPDATE ON MANAGER COMPENSATION[11]

Today McDonald's defines itself as in the need for high-talented, young staff and enters therefore competition to the big industrial corporations in the US. In order to keep the attractiveness of McDonald's, independent consultants compare annually the firm's compensation package to a peer group (mainly companies comprising the Dow Jones Industrial Average Index).

While the meeting of quality standards and short term factors such as profit, sales growth etc. are meant to be guided by a cash compensation system, long term stability is reinforced by not only offering bonuses, but using ownership incentives as well, mainly stock options. Therefore McDonald's applies a general system as follows:

Short Term Incentives

Short term goals and mechanism to achieve them affect mainly the annual salary, by using a standardized framework for all employees. The base salary is dependent on the employee's level of responsibility and his individual level of performance. For example the remuneration at the level of a restaurant manager in the United Kingdom is between 22.000 £ (ca. 35.000 €) and 32.000 £ (about 51.000 €)[12], not included profit bonuses.[13]
The exact amount is determined by the individual performance of the manager during the passed business year - which in return is judged by evaluation.

The variable at-risk incentives are embedded in the "Target Incentive Plan" (TIP): Under TIP, each employee is assigned a target incentive at the beginning of the year - a percentage rate of the target incentive to the salary which increases with rising level of an individual's responsibility (i.e. with higher exposure to risk). In the United States, these target incentives are adjusted for the US operational income, US profit and US cash flow increases, as well as for consumer satisfaction and employee commitment (which is especially important for restaurant managers). Concerning the last two facts, McDonald's emphasizes the following points:

[9] As mentioned earlier in chapter 3.
[10] Compare with Holmstrom, B. - Milgrom, P. (1994).
[11] As long as no other sources are indicated, information is from McDonald's-Proxy (2001)
[12] Great Britain outside Greater London.
[13] Mcdonalds.co.uk (2001).

-Ensuring customer satisfaction with top quality and service
-Recruiting, hiring, training and retraining hourly staff
-Managing costs of food, labor, and other controllables
-Preparing daily and monthly store reports
-Practicing good communications with crew and staff [14]

For the "Rest of World", objectives and their importance change slightly and consist for the very most part of operational income, sales growth, return on assets and consumer satisfaction. In order to avoid windfalls and risks caused by the influence of exchange rates, international targets on an annual basis are defined in constant currency. The same goes for long term incentive objectives.

In France, McDonald's analyze the performance of its restaurants and managers in great detail and therefore implemented a business intelligence program to meet the requirements of management control. Apart from analyzing real estate profits for franchised and owned restaurants, McDonald's analyze performance based on various elements: restaurant location, year of opening, type of operation, etc to highlight key performance criteria for the restaurants and managers.[15]

Long Term Incentives
During the last decade, provision of property right incentives was introduced on a broad range and became reality even for the bottom level of companies' hierarchic structure. McDonald's is no exception. Up from the restaurant manager's levels, stock options have become a main tool aiming for long term profit. At McDonald's stock options typically have a lifetime of ten years, a vest over four to seven years and have an exercise price equal to the fair market value at the grant date. The amount of stock options to receive depends on the level of responsibility, the achievement of plan objectives and the implementation of key strategies.

In addition, McDonald's strongly encourages its employees to participate in ownership of the company. The minimum level of ownership ranges from one to five times the basic salary.

Comparison to other fast food companies
The average salary for a fast food restaurant manager in the United Kingdom ranges from 17.000 £ (~ 26.800 €) to 22.000 £ (~ 34.700 €)[16] for beginners and reaches levels up to 51.000 £ (~ 80.000 €) later (after twenty years of working experience). At the London-based company *PRET A MANGER* a restaurant manager earns between 18.000 £ (~ 28.600 €) and 32.000 £ (~ 51.000 €) a year. In addition one can obtain up to 30% bonus on the annual salary - based on the individual performance.[17]

Compared to the figures cited above, McDonald's attractiveness lies slightly above the average and the rare figures of competitors indicate that the bonus to fixed salary is weighted in a way which is comparable to McDonald's compensation package. Too, the focus on QSC&V (quality, service, cleanliness and value), a concept which has been adapted by most fast food chains, finds it way into the remuneration scheme of almost every company.

[14] Bay Area McDonald's (2001).
[15] Decisionnel (2001).
[16] AGACS (2001).
[17] Pret a manger (2001).

6. SUMMARY

Evaluating the different plans led us to the conclusion that although plan A is somewhat complicated, it seems to be the best proposal. Plan A consists of a base salary determined by a range system and an additional monthly bonus. This bonus depended on how the unit manager was rated by a regional operations staff according to QSC, training ability, volume and profit. The plan gives an adequate distribution of measurement to all the areas important to the unit manager, it corresponds both to short-term individual utility maximizing and to long-term corporate growth.

Other instruments, as distributing property rights by out-sourcing (franchising) have continuously been used parallel to the in-house incentive system to come around the possible cost of a misdirection of tasks. This corresponds well to the complementary instruments of the Holmstrom – Milgrom model. Today, McDonald's have also started using property rights in-house since their current incentive system consists of a combination of short term goals and rewards (annual salary and bonus, "Target Incentive Plan") and long term goal and rewards (stock options).

To make a final sum up that looks into the future: For further development, we believe McDonald's could complement their payment incentives with non-monetary incentives as a clearer and more distinct career path, or use symbolic encouragement in a higher degree.

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APPENDIX 1

Company-operated margins

PERCENT OF SALES	*2000*	*1999*	*1998*
U.S.	17.0%	17.5%	17.3%
Europe	18.3	19.2	20.0
Asia/Pacific	16.2	16.6	16.9
Latin America	12.4	14.1	19.1
Canada, Middle East & Africa	14.5	14.9	16.0
Total	**16.9%**	**17.7%**	**18.4%**

Source: McDonald's Corporate Annual Report

FAST FOOD INDUSTRY 1998

A - COMPANY
B - PROFITABILITY RETURN ON CAPITAL - 5-year average %
C - PROFITABILITY RETURN ON CAPITAL - latest 12 mos %
D - GROWTH - SALES - 5-year average %
E - GROWTH - SALES - latest 12 mos %
F - GROWTH - NET INCOME - 5-year average %
G - GROWTH - NET INCOME - latest 12 mos %
H - SALES - latest 12 mos $ mil
I - NET INCOME - latest 12 mos $ mil
J - OPER MARGIN - latest 12 mos %
K - PROFIT MARGIN - latest 12 mos %

	A	B	C	D	E	F	G	H	I	J	K
Albertson's	19.5	16.8	7.4	7.9	13.3	11.1	15,623	551	8.6	3.5	37.8
Avado Brands	12.2	13.1	39.0	23.4	24.4	102.6	904	70	10.8	7.7	34.8
Bob Evans Farms	10.3	11.2	6.1	8.3	NM	34.3	920	53	13.0	5.8	0.3
Brinker International	10.2	10.3	17.9	16.3	NM	21.0	1,631	73	12.9	4.5	20.4
Buffets	9.8	12.4	26.0	7.1	14.5	45.2	852	37	12.0	4.4	11.7
Casey's General	10.4	10.5	11.8	0.7	19.5	21.8	990	37	9.9	3.8	19.5
CKE Restaurants	13.6	13.1	15.5	106.6	NM	115.6	1,675	71	12.4	4.2	49.9
Cracker Barrel	13.9	13.3	20.5	15.1	16.5	16.5	1,356	107	15.8	7.9	6.9
Food Lion	11.5	14.1	6.7	5.4	NM	81.6	10,264	275	7.3	2.7	37.0
Hannaford Bros	10.9	9.3	10.3	7.2	6.0	-14.3	3,344	68	8.2	2.0	31.4
McDonald's	13.1	12.4	10.9	7.8	12.0	-1.8	12,153	1,613	31.4	13.3	37.4
Outback Steakhouse	30.4	19.3	54.6	19.7	39.3	0.5	1,312	76	15.8	5.8	7.0
Performance Food	13.5	9.2	29.9	33.7	39.9	16.8	1,49	15	2.5	1.0	32.3
Richfood Holdings	18.7	12.1	7.4	5.3	32.6	-18.7	3,556	54	4.8	1.5	67.0
Royal Ahold	9.9	6.5	15.9	38.4	16.0	37.9	26,642	375	6.0	1.4	33.7
Ruddick	10.1	9.2	7.1	8.1	10.6	-2.0	2,487	47	6.0	1.9	29.0
Safeway	19.3	16.7	7.1	20.6	46.8	37.4	24,347	767	8.4	3.2	45.5
Sysco	14.5	15.3	9.1	7.5	10.4	7.1	15,692	331	5.0	2.1	35.0
Whole Foods Market	7.2	16.3	25.7	24.4	NM	70.4	1,39	45	8.1	3.3	37.4

NM: Not meaningful.